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FEDERAL VALUATION OF RAILROADS—DISCUSSION

E. W. BEMIS.—The burden of Professor Bauer's paper is that a final value should be placed upon the railroad property of the United States as a foundation for taxation, regulation, issuance of securities, public purchase, or other public purposes, and he criticises the Railroad Valuation Act approved March 1, 1913, because of its failure to call for such a single or final value.

It would indeed be desirable to have such a final value if it could be obtained without too great a sacrifice at this time of the public interests, and if such a final valuation when obtained could be equally applicable for all the above named purposes. Unfortunately, however, none of these conditions is present today. There is the widest diversity of opinion as to the weight to be given to the history of the investment, the cost of the property now in use, the depreciation of the same, the extent to which it was paid for out of surplus earnings or depreciation reserve or maintenance charges, and the cost of reproducing the property less accrued depreciation of the same. There is even great difference of opinion as to whether the original cost of the property now in use should be estimated where the records are not clear but where data can be obtained from the cost of similar properties in the neighborhood built at about the same time. Sharp differences also exist as to whether the reproduction cost of the land should be the cost of acquiring the same today or the value of adjoining lands, as set forth in the Minnesota Rate Case. A new element of doubt has been thrown into the whole matter by the forcible presentation before the Interstate Commerce Commission of the legal argument by an able Chicago lawyer representing the Railroad Brotherhoods, that under the charters of most of our roads and the constitutions or common law of most of our states the railroads have no right to earn on more than the cost to the original investors. All unearned increments, it is contended, represent the public interest and are not a basis for determining rates or the price to be paid in case of public condemnation and purchase. Furthermore, it is clear that different principles apply in the valuation of property for purposes of taxation, and possibly of purchase, from those that apply in case of rate regulation. Under all these circumstances the most practicable thing to do in the present railroad valuation work is to carry out the purpose of the act and set up these various elements, such as investment history, the original cost, reproduction cost and the depreciation of each; and then with the significance of the various theories of valuation clearly

before our commissions and courts, the determination of a final value can be ultimately reached.

The difficulties are so great in even working out these essentials—to each of which some weight at least must be given in any final valuation—that it is clear that if the act had required a final valuation at the present time it would have been impossible to have carried it out. In addition to the above reasons, another powerfully affected the writer in using such influence as he had with the Senate Committee on Interstate Commerce in January and February, 1913, in shaping the act so as to prevent a final valuation at present. This reason was the certainty that a final valuation fixed as an academic or court procedure when no rate case was before the Interstate Commerce Commission would result in the failure of shipping organizations and the public generally to represent the public interests as vigorously as the railroads—always alert—would represent the private interests. The hearings of the last three years in Washington before the Commission have completely proved this contention; the public interests have only been represented before the Commission by a few men, rarely exceeding half a dozen, and with expenditure of less than \$20,000 a year, while the private interest of the railroad companies has been represented by several times as many men and very many times as much money.

After the valuation work has been completed along the present lines, at an expenditure of perhaps \$25,000,000 or \$30,000,000, the results taken in connection with the work called for by the Valuation Act in keeping the valuation up to date will enable a final value to be quickly determined according to the purpose of the valuation and the theoretical views at that time entertained by the valuing body. Meantime, if the government takes over the roads, the work now half finished and going forward rapidly will be invaluable in assisting in the determination of the price the government will pay in the final adjustment. In short, Professor Bauer has in the main laid down excellent suggestions for ultimate use, although I do not agree with all of them, but has underestimated the dangers of loading down our present railroad valuation work with the determination of a final value. With every year's postponement of that determination, public opinion is becoming educated and the chance of protecting the public interest is becoming correspondingly greater. The final valuation, determined after the present railroad valuation is concluded, will be a very different and, it is believed, much lower figure than would have been fixed had the final valuation been written into the act and taken up four years ago. The reproduction theory is now losing ground and studies of investment and

original cost are daily assuming greater importance in the public mind—and justly so.

THOMAS W. HULME.—The speaker does not confine himself solely to the relation of valuation to the question of a national policy of railway control, as he evidently deems it essential for the purpose of fully presenting his views to enter into a discussion of collateral questions. I purpose, however, to utilize the limited time available by confining my remarks solely to the question of the relationship of the federal valuation to a national policy of railway control.

Professor Bauer reaches the conclusion that federal valuations should determine the amount upon which each carrier shall have the right to earn a return. It is not necessary to here discuss whether the Valuation Act of March 1, 1913, provides for a valuation for *rate making* or for a *true value* as generally understood at the time of the passage of the act, but rather whether the ascertainment of a rate base or the ascertainment of the true value would be more helpful in the determination of a national policy with reference to railway control.

I hold the view that, while information for the judgment of rates is of great importance, it is not the sole or only element in the determination of a national railway policy. Service is of primary importance. For some time it has been evident that in the eastern section of the country the railroad plant is not equal to the demands upon it. It must, therefore, be enlarged, and the most important thing in the determination of a national policy with reference to the railroads rests upon the ascertainment of the best means of providing capital not only now, but in the future, with which to meet these requirements. The regulation of railroads has for so many years been in the direction of reduction of rates that capital has for some time been difficult to obtain to provide additional facilities. In this connection the Hadley Commission was created some years ago to investigate and make a report upon the regulation of railway capital issues. It recommended that Congress should not attempt to assume control thereof until an investigation had been made as to the financial history of the railroad companies and a valuation made of their properties. The wisdom of this report was so generally recognized that it was the most influential factor in bringing about the passage of the Valuation Act, which directs that there should be ascertained for the information of Congress not only the Original Cost, the Cost of Reproduction, and the Cost of Reproduction less Depreciation, but also all other Values and Elements of Value. In order that Congress may also be fully informed as to the financial history of the railroad companies, the report should show the amount

of all capital issues, the disposition of all earnings, and the amount of property received through aids, gifts, grants or donations. Congress thus specifically indicated that it desired all information.

It does not seem reasonable that Congress should have taken the Hadley report as a reason for legislation and have directed so great an expenditure of time and money without intending that all essential information should be obtained; nor does it seem reasonable to those familiar with the proceedings of a legislative body that Congress expected that a great mass of undigested information would be sent to it without the drawing therefrom of specific findings which would indicate *the relationship of value to capital issues*, to the *generally discussed question of government ownership*, and other pertinent questions.

Are not those relationships essential in determining a national policy? For at least two years following the passage of the Valuation Act it was generally understood that it required the finding of value. While the National Association of Railway Commissioners opposed such findings and the Bureau of Valuation proceeded only so far as to prepare inventories, it was not until the solicitor of the Bureau of Valuation, on December 12, 1917, at a hearing before the Interstate Commerce Commission, stated that the investigations were being made to ascertain facts which would be serviceable in rate making, that an authoritative statement was made as to the underlying basis of the federal valuation work. Such an investigation excludes something. The extent of the exclusion depends upon what is *fair* in the minds of those who are determining the rate base. Such a report will show what is included, but it will not show what is excluded. It is, therefore, pertinent to inquire as to what is considered *fair* by those who advocate the rate base.

Director Prouty contends that value for rate making is an administrative matter, falling within the principle of the line of decisions which hold that, where the determination of a fact is essential to the exercise of an executive or an administrative duty, the correctness of that conclusion cannot be questioned by the courts. He did not contend that legal errors should not be corrected by the courts, but he did contend that the review of the situation should not be to determine whether the rate was a reasonable one, but rather whether it so far passes the limits of just regulation as to destroy the property of the utility.

More recently the Director has stated that a rate base is not exchange value, but is "that sum upon which under all the circumstances, upon a fair consideration of all the facts and elements to be taken into account, a fair return should be permitted."

I know that there is a very clear distinction in his mind between true

value and his proposed rate base. True value not only takes into consideration cost and the condition of the physical elements, but also the benefits arising from the use thereof. In any appropriation of property the taker must pay for the benefits of the use as well as the property. If our government contemplates the taking of railroad properties it must pay for them on such a basis. For years railroad properties have been bought and sold upon such a basis, and security issues have been made which have been widely distributed; and anyone who feels that such a condition can be ignored without a departure from justice resulting in the greatest economical disturbance, need only read the report of the Hadley Commission to be convinced to the contrary.

As the Bureau of Valuation is not undertaking to determine value, it is pertinent to inquire to what extent the conduct of this work falls short of what should be done to enable the federal valuation work to be of full service in the determination of a national policy. In other words, what are they failing to include in their report? They know that even for rate making an inventory of the "bare bones" of the property is not sufficient. They know that a value for going-concern must be included. Most of the decisions of our courts have been in rate-making cases and clearly require such a finding. It is not contended that going-concern value is necessarily the equivalent of a true value which includes the full value of the business. Judge Prouty clearly indicated, some years ago, in a speech in this building, his understanding of these facts.

It is my contention that the *federal valuation work should include the finding of true value*; that the *report should include the elements that represent value*, so that any use thereof may be made which may be proper.

I doubt whether there would be so much contention over the principles in the valuation work if it were not that the carriers of this country are contending for the ascertainment of the true value of their properties, whereas the Bureau of Valuation is conducting its work from a rate-making standpoint. If the carriers' attitude be sustained, all information required for any purpose will be available; if the attitude of the Bureau of Valuation be approved, there will only be available the figures which in the judgment of those now doing the work will be serviceable in a rate case. Can anyone doubt which will be the most helpful in the establishment of a proper policy of national railway control?

RALPH E. HEILMAN.—Professor Bauer's constructive proposal regarding valuation seems to me to be eminently sound, just, and practi-

cable. But I do not feel that the same can be said for his proposal regarding rate making.

If the valuation now being conducted by the Interstate Commerce Commission, or any other valuation, is to be used to fix once for all the rate-making value of past investments, presumably reproductive or replacement value should be given the major importance. This is more in harmony with the prevailing legal standards; it would recognize the expectations of investors, and, further, it is necessitated in many cases by the lack of any reliable data as to what the installation cost actually was.

But while justice and expediency may unite in requiring such treatment for past investments, the same is not true of future investments. The program of fixing the value of past investments largely upon a basis of replacement cost, and of future investments upon actual cost, is not in any sense inconsistent with itself. Such a program would merely recognize the mistakes of the past, for which the public is partially responsible, would provide against their recurrence, and would definitely settle the problem of valuation. Such a plan, in substance, has now been in operation with the street railways of Chicago since 1907.

Among possible objections to such a plan, it is suggested that its application to the railroads might mean that the same method would be imposed upon all other utilities. This, instead of constituting an objection, is a further consideration in its favor. The various state public utility and public service commissions, under the power given to them to prescribe uniform accounting systems, are now building up a large and growing body of data and information regarding the actual costs of all property constructed in recent years, particularly since 1907. It is certainly undesirable that these regulating bodies should continue, throughout the future, to use reproductive cost for those portions of the properties constructed since the establishment of commission control over accounts, and of which actual costs are definitely known. Certainly there is no justification for valuation by conjecture and supposition when the facts are accurately known or ascertainable.

But the method in which the author proposes to use this valuation, namely, by a strict limitation upon profits, is one which would greatly impair operating efficiency. With earnings absolutely limited at a fixed point, what inducement would there be to experimentation, increased efficiency, reducing the costs of operation, or economies in management?

Whatever may be said regarding the defects of our present system of regulating utility rates, it does have the virtue of inducing and rewarding efficiency. Specific rates are set at a given point—estimated

to produce a certain return. If, while such rates are in effect, the company can by increased efficiency lower its costs of operation, it profits by that fact until rates are again lowered, which may be for a considerable period. It might be better if we were frankly and openly to recognize the necessity of inducing and rewarding efficiency, by some system of bonus, or otherwise. Such a recognition is contained in the Chicago street railway plan, under which the companies obtain a 5 per cent return upon their capital account, plus 45 per cent of the excess earnings, the other 55 per cent going to the city.

At some points in his paper Professor Bauer recognizes the necessity for some such inducement, although he does not state how it is to be provided, nor how it is to be fitted in with a plan which rigidly limits earnings. But until we have devised some other plan of inducing and rewarding efficiency, it would be unwise to abandon the present system, and to introduce in its stead a plan, not of regulating rates, but of fixing profits—a plan which would inevitably lead to slackness, inefficiency of operation, and lack of progress.

JOHN R. COMMONS.—It should be remembered that Congress in directing the value work to be done by the Interstate Commerce Commission did not before have any actual valuation of any particular road or system. The Interstate Commerce Commission, to ascertain the various elements which are under dispute in making up the final valuation, then directed Congress to keep these valuations up to date, so that when an actual case arose before the Commission the valuation could promptly be made for the purpose of that case. Had Congress directed the Commission to establish final valuation prior to the case upon which it was making the decision, the valuation would have been merely that of a moot case and would have had no legal standing.

JOHN A. RYAN.—I should like to ask two questions. Since the Supreme Court has not always included precisely the same elements in its definitions or standards of fair value, is it not probable that a formal declaration by Congress, enacting its own conception of fair value into law, would be accorded a considerable amount of authority by the court? Therefore, it seems to me that Professor Bauer is right in contending for such a legislative declaration and definition. My second question is this: If the railroads should at the close of the war be purchased by the government for the capitalized value of the annual rental paid to their owners during the war, would not all the expenditure for valuation have been in vain?